Advanced Accounting

13th Edition

Floyd A. Beams
Joseph H. Anthony
Bruce Bettinghaus
Kenneth Smith

Pearson

ADVANCED ACCOUNTING

This page intentionally left blank

ADVANCED
ACCOUNTING

13TH EDITION

Floyd A. Beams
Virginia Polytechnic Institute
and State University

Joseph H. Anthony
Michigan State University

Bruce Bettinghaus
Grand Valley State University

Kenneth A. Smith
Central Washington University

Pearson

New York, NY

Vice President, Business Publishing: Donna Battista
Director of Portfolio Management: Adrienne D'Ambrosio
Director, Courseware Portfolio Management: Ashley Dodge
Senior Sponsoring Editor: Neeraj Bhalla
Vice President, Product Marketing: Roxanne McCarley
Director of Strategic Marketing: Brad Parkins
Strategic Marketing Manager: Deborah Strickland
Product Marketer: Tricia Murphy
Field Marketing Manager: Natalie Wagner
Field Marketing Assistant: Kristen Compton
Product Marketing Assistant: Jessica Quazza
Vice President, Production and Digital Studio, Arts and Business: Etain O'Dea
Director of Production, Business: Jeff Holcomb
Managing Producer, Business: Ashley Santora
Operations Specialist: Carol Melville
Creative Director: Blair Brown
Manager, Learning Tools: Brian Surette
Content Developer, Learning Tools: Sarah Peterson
Managing Producer, Digital Studio, Arts and Business: Diane Lombardo
Digital Studio Producer: Regina DaSilva
Digital Studio Producer: Alana Coles
Digital Content Team Lead: Noel Lotz
Digital Content Project Lead: Martha Lachance
Full-Service Project Management and Composition: SPi Global
Interior Design: SPi Global
Cover Design: SPi Global
Cover Art: Yuttasak Jannarong/Shutterstock
Printer/Binder: Courier Digital Solutions
Cover Printer: Courier Digital Solutions

Copyright © 2018, 2015, 2012 by Pearson Education, Inc. or its affiliates. All Rights Reserved. Manufactured in the United States of America. This publication is protected by copyright, and permission should be obtained from the publisher prior to any prohibited reproduction, storage in a retrieval system, or transmission in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise. For information regarding permissions, request forms, and the appropriate contacts within the Pearson Education Global Rights and Permissions department, please visit www.pearsoned.com/permissions/.

Acknowledgments of third-party content appear on the appropriate page within the text.

PEARSON, ALWAYS LEARNING are exclusive trademarks owned by Pearson Education, Inc. or its affiliates in the U.S. and/or other countries.

Unless otherwise indicated herein, any third-party trademarks, logos, or icons that may appear in this work are the property of their respective owners, and any references to third-party trademarks, logos, icons, or other trade dress are for demonstrative or descriptive purposes only. Such references are not intended to imply any sponsorship, endorsement, authorization, or promotion of Pearson's products by the owners of such marks, or any relationship between the owner and Pearson Education, Inc., or its affiliates, authors, licensees, or distributors.

This publication includes quotations from portions of GASB and FASB documents, copyrighted by the Financial Accounting Foundation (FAF), 401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116, U.S.A. Such quotations are reprinted with permission. Complete copies of these documents are available from the FAF

Library of Congress Cataloging-in-Publication Data

Names: Beams, Floyd A., author.
Title: Advanced accounting / Floyd A. Beams, Virginia Polytechnic Institute and State University, Joseph H. Anthony, Michigan State University, Bruce Bettinghaus, Grand Valley State University, Kenneth A. Smith, Central Washington University.
Description: 13th Edition. | New York : Pearson Education, [2016] | Revised edition of: Advanced accounting, [2015]
Identifiers: LCCN 2016050010| ISBN 9780134472140 | ISBN 0134472144
Subjects: LCSH: Accounting.
Classification: LCC HF5636 .B43 2016 | DDC 657/.046—dc23 LC record available at https://lccn.loc.gov/2016050010

10 9 8 7 6 5 4 3 2 1

Pearson

ISBN-10: 0-13-447214-4
ISBN-13: 978-0-13-447214-0

To Beth

Joe Anthony

To Trish

Bruce Bettinghaus

To Karen, Madelyn and AJ

Kenneth A. Smith

This page intentionally left blank

ABOUT THE AUTHORS

FLOYD A. BEAMS, PH.D., authored the first edition of *Advanced Accounting* in 1979 and actively revised his text through the next six revisions and twenty-one years while maintaining an active professional and academic career at Virginia Tech where he rose to the rank of Professor, retiring in 1995.

Beams earned his B.S. and M.A. degrees from the University of Nebraska, and a Ph.D. from the University of Illinois. He published actively in journals, including *The Accounting Review*, *Journal of Accounting*, *Auditing and Finance*, *Journal of Accountancy*, *The Atlantic Economic Review*, *Management Accounting*, and others. He was a member of the American Accounting Association and the Institute of Management Accountants and served on committees for both organizations. Beams was honored with the National Association of Accounts' Lybrand Bronze Medal Award for outstanding contribution to accounting literature, the Distinguished Career in Accounting award from the Virginia Society of CPAs, and the Virginia Outstanding Accounting Educator award from the Carman G. Blough student chapter of the Institute of Management Accountants. Professor Beams passed away in 2004; however, we continue to honor his contribution to the field and salute the impact he had on this volume.

JOSEPH H. ANTHONY, PH.D., joined the Michigan State University faculty in 1983 and is an Associate Professor of Accounting at the Eli Broad College of Business. He earned his B.A. in 1971 and his M.S. in 1974, both awarded by Pennsylvania State University, and he earned his Ph.D. from The Ohio State University in 1984. He is a Certified Public Accountant, and is a member of the American Accounting Association, American Institute of Certified Public Accountants, American Finance Association, and Canadian Academic Accounting Association. He has been recognized as a Lilly Foundation Faculty Teaching Fellow and as the MSU Accounting Department's Outstanding Teacher in 1998–1999 and in 2010–2011. He is retiring in May 2016.

Anthony teaches a variety of courses, including undergraduate introductory, intermediate, and advanced financial accounting. He also teaches financial accounting theory and financial statement analysis at the master's level, as well as financial accounting courses in Executive MBA programs, and a doctoral seminar in financial accounting and capital markets research. He co-authored an introductory financial accounting textbook.

Anthony's research interests include financial statement analysis, corporate reporting, and the impact of accounting information in the securities markets. He has published a number of articles in leading accounting and finance journals, including *The Journal of Accounting & Economics*, *The Journal of Finance*, *Contemporary Accounting Research*, *The Journal of Accounting*, *Auditing*, *& Finance*, and *Accounting Horizons*.

BRUCE BETTINGHAUS, PH.D., is an Associate Professor of Accounting in the School of Accounting in The Seidman College of Business at Grand Valley State University. His teaching experience includes corporate governance and accounting ethics, as well as accounting theory and financial reporting for both undergraduates and graduate classes. He earned his Ph.D. at Penn State University and his B.B.A. at Grand Valley State University. Bruce has also served on the faculties of the University of Missouri and Michigan State University. He has been recognized for high-quality teaching at both Penn State and Michigan State Universities. His research interests focus on governance and financial reporting for public firms. He has published articles in *The International Journal of Accounting, Management Accounting Quarterly, Strategic Finance,* and *The Journal of Corporate Accounting and Finance*.

KENNETH A. SMITH, PH.D., is an Associate Professor of Accounting and the Department Chair at Central Washington University. He earned his Ph.D. from the University of Missouri, his M.B.A. from Ball State University, and his B.A. in Accounting from Anderson University (IN). He is a Certified Public Accountant. Smith's research interests include government accounting and budgeting, non-profit financial management, non-financial performance reporting, and information systems in government and non-profit organizations. He has published articles in such journals as *Accounting Horizons*, *Journal of Government Financial Management*, *Public Performance & Management Review*, *Nonprofit and Voluntary Sector Quarterly*, *International Public Management Journal*, *Government Finance Review*, and *Strategic Finance.*

Smith's professional activities include membership in the American Accounting Association, the Association of Government Accountants, the Government Finance Officers Association, the Institute of Internal Auditors, and the Institute of Management Accountants. He is an elected public official, serving on the School Board for the 10th largest School District in the state of Washington. He formerly served as the Executive Director for the Oregon Public Performance Measurement Association and the not-for-profit Wheels for Humanity.

This page intentionally left blank

BRIEF CONTENTS

Preface xvii

CHAPTER 1
Business Combinations 1

CHAPTER 2
Stock Investments—Investor Accounting and Reporting 29

CHAPTER 3
An Introduction to Consolidated Financial Statements 63

CHAPTER 4
Consolidation Techniques and Procedures 97

CHAPTER 5
Intercompany Profit Transactions—Inventories 147

CHAPTER 6
Intercompany Profit Transactions—Plant Assets 187

CHAPTER 7
Intercompany Profit Transactions—Bonds 221

CHAPTER 8
Consolidations—Changes in Ownership Interests 249

CHAPTER 9
Indirect and Mutual Holdings 279

CHAPTER 10
Subsidiary Preferred Stock, Consolidated Earnings per Share, and Consolidated Income Taxation 313

CHAPTER 11
Consolidation Theories, Push-Down Accounting, and Corporate Joint Ventures 363

CHAPTER 12
Derivatives and Foreign Currency: Concepts and Common Transactions 399

CHAPTER 13
Accounting for Derivatives and Hedging Activities 419

CHAPTER 14
Foreign Currency Financial Statements 449

CHAPTER 15
Segment and Interim Financial Reporting 481

CHAPTER 16
Partnerships—Formation, Operations, and Changes in Ownership Interests 507

CHAPTER 17
Partnership Liquidation 543

CHAPTER 18
Corporate Liquidations and Reorganizations 571

CHAPTER 19
An Introduction to Accounting for State and Local Governmental Units 605

CHAPTER 20
Accounting for State and Local Governmental Units—Governmental Funds 643

CHAPTER 21
Accounting for State and Local Governmental Units—Proprietary and Fiduciary Funds 691

CHAPTER 22
Accounting for Not-for-Profit Organizations 717

CHAPTER 23
Estates and Trusts 753

Glossary *G-1*

Index *I-1*

This page intentionally left blank

CONTENTS

Preface xvii

CHAPTER 1

Business Combinations 1

Reasons For Business Combinations 2
Antitrust Considerations 3
Legal Form of Business Combinations 4
Accounting Concept of Business Combinations 5
Accounting for Combinations as Acquisitions 6
Disclosure Requirements 13
The Sarbanes-Oxley Act 16
Appendix: Pooling of Interests Accounting

CHAPTER 2

Stock Investments—Investor Accounting and Reporting 29

Accounting for Stock Investments 29
Equity Method—A One-Line Consolidation 32
Investment in a Step-By-Step Acquisition 39
Sale of an Equity Interest 40
Stock Purchases Directly from the Investee 40
Investee Corporation With Preferred Stock 41
Discontinued Operations and other Considerations 42
Disclosures for Equity Investees 42
Testing Goodwill for Impairment 44

CHAPTER 3

An Introduction to Consolidated Financial Statements 63

Business Combinations Consummated Through Stock Acquisitions 63
Consolidated Balance Sheet at Date of Acquisition 66
Consolidated Balance Sheets After Acquisition 70
Assigning Excess to Identifiable Net Assets and Goodwill 72
Consolidated Income Statement 78
Push-Down Accounting 79
Preparing a Consolidated Balance Sheet Worksheet 81

CHAPTER 4
Consolidation Techniques and Procedures 97

Consolidation Under the Equity Method 97
Locating Errors 104
Excess Assigned to Identifiable Net Assets 104
Consolidated Statement of Cash Flows 109
Preparing a Consolidation Worksheet 115
Appendix A: Trial Balance Workpaper Format
Consolidation Example—Trial Balance Format and Equity Method
Appendix B: Preparing Consolidated Statements when Parent Uses Either the Incomplete Equity Method or the Cost Method
Consolidation Under an Incomplete Equity Method
Consolidation Under the Cost Method

CHAPTER 5
Intercompany Profit Transactions—Inventories 147

Intercompany Inventory Transactions 148
Downstream and Upstream Sales 152
Unrealized Profits From Downstream Sales 155
Unrealized Profits From Upstream Sales 157
Consolidation Example—Intercompany Profits From Downstream Sales 160
Consolidation Example—Intercompany Profits From Upstream Sales 162
Appendix: The 1933 Securities Act
The Securities Exchange Act of 1934
The Sarbanes-Oxley Act
The Registration Statement for Security Issues
The Integrated Disclosure System
Sec Developments

CHAPTER 6
Intercompany Profit Transactions—Plant Assets 187

Intercompany Profits on Nondepreciable Plant Assets 187
Intercompany Profits on Depreciable Plant Assets 192
Plant Assets Sold at other than Fair Value 200
Consolidation Example—Upstream and Downstream Sales of Plant Assets 201
Inventory Purchased for Use as an Operating Asset 204

CHAPTER 7
Intercompany Profit Transactions—Bonds 221

Intercompany Bond Transactions 221
Constructive Gains and Losses on Intercompany Bonds 222
Parent Bonds Purchased by Subsidiary 224
Parent Purchases Subsidiary Bonds 230

CHAPTER 8
Consolidations—Changes in Ownership Interests 249

Acquisitions During an Accounting Period 249
Piecemeal Acquisitions 252
Sale of Ownership Interests 254
Changes in Ownership Interests from Subsidiary Stock Transactions 260
Stock Dividends and Stock Splits by a Subsidiary 263

CHAPTER 9
Indirect and Mutual Holdings 279

Affiliation Structures 279
Indirect Holdings—Father-Son-Grandson Structure 281
Indirect Holdings—Connecting Affiliates Structure 284
Mutual Holdings—Parent Stock Held by Subsidiary 288
Subsidiary Stock Mutually Held 296

CHAPTER 10
Subsidiary Preferred Stock, Consolidated Earnings per Share, and Consolidated Income Taxation 313

Subsidiaries with Preferred Stock Outstanding 313
Parent and Consolidated Earnings Per Share 319
Subsidiary With Convertible Preferred Stock 322
Subsidiary With Options and Convertible Bonds 323
Income Taxes of Consolidated Entities 324
Income Tax Allocation 325
Separate-Company Tax Returns with Intercompany Gain 328
Effect of Consolidated and Separate-Company Tax Returns on Consolidation Procedures 332
Business Combinations 339
Financial Statement Disclosures for Income Taxes 344

CHAPTER 11
Consolidation Theories, Push-Down Accounting, and Corporate Joint Ventures 363

Comparison of Consolidation Theories 364
Illustration—Consolidation Under Parent-Company and Entity Theories 366
Push-Down Accounting and other Basis Considerations 373
Joint Ventures 380
Accounting for Variable Interest Entities 383

CHAPTER 12
Derivatives and Foreign Currency: Concepts and Common Transactions 399

Derivatives 399
Foreign Exchange Concepts and Definitions 404
Foreign Currency Transactions other than Forward Contracts 406

CHAPTER 13
Accounting for Derivatives and Hedging Activities 419

Accounting for Derivative Instruments and Hedging Activities 419
Accounting for Hedge Contracts: Illustrations of cash Flow and Fair-Value Hedge Accounting Using Interest Rate Swaps 428
Foreign Currency Derivatives and Hedging Activities 431

CHAPTER 14
Foreign Currency Financial Statements 449

Objectives of Translation and the Functional Currency Concept 449
Application of the Functional Currency Concept 451
Illustration: Translation 455
Illustration: Remeasurement 461
Hedging a Net Investment in a Foreign Entity 465

CHAPTER 15
Segment and Interim Financial Reporting 481

Segment Reporting 481
Interim Financial Reporting 487
Guidelines for Preparing Interim Statements 489

CHAPTER 16
Partnerships—Formation, Operations, and Changes in Ownership Interests 507

Nature of Partnerships 507
Initial Investments in a Partnership 508
Additional Investments and Withdrawals 510
Partnership Operations 511
Profit- and Loss-Sharing Agreements 512
Changes in Partnership Interests 518
Purchase of an Interest from Existing Partners 519
Investing in an Existing Partnership 522
Dissociation of a Continuing Partnership Through Death or Retirement 524
Limited Partnerships 526

CHAPTER 17
Partnership Liquidation 543

The Liquidation Process 543
Safe Payments to Partners 547
Installment Liquidations 549
Cash Distribution Plans 555
Insolvent Partners and Partnerships 557

CHAPTER 18

Corporate Liquidations and Reorganizations 571

Bankruptcy Reform act of 1978 571
Liquidation 574
Illustration of a Liquidation Case 575
Reorganization 583
Financial Reporting During Reorganization 587
Financial Reporting for the Emerging Company 588
Illustration of a Reorganization Case 589

CHAPTER 19

An Introduction to Accounting for State and Local Governmental Units 605

Historical Development of Accounting Principles for State and Local Governmental Units 605
Overview of Basic Governmental Accounting Models and Principles 607
The Financial Reporting Entity 618
Comprehensive Annual Financial Report 619

CHAPTER 20

Accounting for State and Local Governmental Units—Governmental Funds 643

Recent Changes to Governmental Fund Accounting 643
The General Fund 644
Accounting for the General Fund 644
Permanent Funds 657
Capital Projects Funds 658
Special Assessment Activities 662
Debt Service Funds 663
Accounting for the Debt Service Fund 663
Governmental Fund Financial Statements 665
Preparing the Government-Wide Financial Statements 668

CHAPTER 21

Accounting for State and Local Governmental Units—Proprietary and Fiduciary Funds 691

Proprietary Funds 691
Internal Service Funds 692
Enterprise Funds 696
Proprietary Fund Financial Statements 700
Fiduciary Funds 702
Preparing the Government-Wide Financial Statements 706
Required Proprietary Fund Note Disclosures 707

CHAPTER 22

Accounting for Not-for-Profit Organizations 717

The Nature of Not-For-Profit Organizations 717
Not-For-Profit Accounting Principles 718
Voluntary Health and Welfare Organizations 723
“Other” Not-For-Profit Organizations 730
Nongovernmental Not-For-Profit Hospitals and other Health Care Organizations 730
Private Not-For-Profit Colleges and Universities 735

CHAPTER 23

Estates and Trusts 753

Creation of An Estate 753
Probate Proceedings 754
Administration of the Estate 754
Accounting for the Estate 755
Illustration of Estate Accounting 756
Accounting for Trusts 760
Estate Taxation 761

Glossary G-1

Index I-1

PREFACE

NEW TO THIS EDITION

Important changes in the 13th edition of *Advanced Accounting* include the following:

- The text has been rewritten to align with both the *Financial Accounting Standards Board Accounting Standards Codification* and the *Governmental Accounting Standards Board Codification*. References to original pronouncements have been deleted, except where important in an historical context.
- The text now provides references to official pronouncements parenthetically within the text. Text length is reduced and rendered much more readable for the students. References to the Codification appear parenthetically (e.g., ASC 740-10-15).
- End of chapter materials have been modified to include Professional Research assignments. These assignments require students to access the authoritative literature. Solutions offered to these assignments are up to date as of May 2016. Instructors will want to verify that those have not changed.
- All chapters have been updated to include coverage of the latest international reporting standards and issues, where appropriate. As U.S. and international reporting standards move toward greater harmonization, the international coverage continues to expand in the 13th edition.
- All chapters have been updated to reflect the most recent changes to the *Financial Accounting Standards Board Codification* and *Governmental Accounting Standards Board Codification*.
  - Chapter 16 has been modified to clarify GAAP/non-GAAP issue with partnership accounting in instances where the addition of a new partner may constitute a business combination.
- The governmental and not-for-profit chapters have been updated to include all standards through *GASB No. 81*. These chapters have also been enhanced with illustrations of the financial statements from Golden, Colorado. Coverage now includes the new financial statement elements (deferred inflows and outflows), as well as several new pension standards. Chapter 20 includes an exhibit with t-accounts to help students follow the governmental fund transactions and their financial statement impact.
- Chapter 23 coverage of fiduciary accounting for estates and trusts has been revised and updated to reflect current taxation of these entities as of December 31, 2015. Assignment materials have been modified to enhance student learning.

This 13th edition of *Advanced Accounting* is designed for undergraduate and graduate students majoring in accounting. This edition includes 23 chapters designed for financial accounting courses beyond the intermediate level. Although this text is primarily intended for accounting students, it is also useful for accounting practitioners interested in preparation or analysis of consolidated financial statements, accounting for derivative securities, and governmental and not-for-profit accounting and reporting. This 13th edition has been thoroughly updated to reflect recent business developments, as well as changes in accounting standards and regulatory requirements.

This comprehensive textbook addresses the practical financial reporting problems encountered in consolidated financial statements, goodwill, other intangible assets, and derivative securities. The text also includes coverage of foreign currency transactions and translations, partnerships, corporate liquidations and reorganizations, governmental accounting and reporting, not-for-profit accounting, and estates and trusts.

An important feature of the 13th edition is the continued student orientation, which has been further enhanced with this edition. This 13th edition strives to maintain an interesting and readable text for the students. The focus on the complete equity method is maintained to allow students to focus on accounting concepts rather than bookkeeping techniques in learning the consolidation materials. This edition also maintains the reference text quality of prior editions through the use of appendices to the consolidation chapters. These appendices cover pooling of interests accounting, trial balance workpaper formats, and easy to understand conversions from an incomplete equity method or cost method to the complete equity method. Students can then follow the main text approach to preparing consolidated financial statements using the complete equity method. The presentation of consolidation materials highlights working paper-only entries with shading and presents working papers on single upright pages. All chapters include current excerpts from the popular business press and references to familiar real-world companies, institutions, and events. This book uses examples from annual reports of well-known companies and governmental and not-for-profit institutions to illustrate key concepts and maintain student interest. Assignment materials include adapted items from past CPA examinations and have been updated and expanded to maintain close alignment with coverage of the chapter concepts. Assignments have been updated to include additional research cases and simulation-type problems, as well as the Professional Research assignments mentioned previously. This edition maintains identification of names of parent and subsidiary companies beginning with P and S, allowing immediate identification. It also maintains parenthetical notation in journal entries to clearly indicate the direction and types of accounts affected by the transactions. The 13th edition retains the use of learning objectives throughout all chapters to allow students to better focus study time on the most important concepts.

ORGANIZATION OF THIS BOOK

Chapters 1 through 11 cover business combinations, the equity, fair value and cost methods of accounting for investments in common stock, and consolidated financial statements. This emphasizes the importance of business combinations and consolidations in advanced accounting courses as well as in financial accounting and reporting practices.

Accounting and reporting standards for acquisitions are introduced in Chapter 1. Chapter 1 also provides necessary background material on the form and economic impact of business combinations. The Appendix to Chapter 1 provides a summary on Pooling of Interests Accounting. Chapter 2 introduces the complete equity method of accounting as a one-line consolidation, and this approach is integrated throughout subsequent chapters on consolidations. This approach permits alternate computations for such key concepts as consolidated net income and consolidated retained earnings, and it helps instructors explain the objectives of consolidation procedures. The alternative computational approaches also assist students by providing a check figure for their logic on these key concepts. The one-line consolidation is maintained as the standard for a parent company in accounting for investments in its subsidiaries. Chapter 3 introduces the preparation of consolidated financial statements. Students learn how to record the fair values of the subsidiary’s identifiable net assets and implied goodwill. Chapter 4 continues consolidations coverage, introducing working paper techniques and procedures. The text emphasizes the three-section, vertical financial statement working paper approach throughout, but Appendix A to Chapter 4 also offers a trial balance approach. The standard employed throughout the consolidation chapters is working papers for a parent company that uses the complete equity method of accounting for investments in subsidiaries. Appendix B to Chapter 4 provides a clear approach to convert from either the Incomplete Equity Method or the Cost Method to the complete equity method of accounting.

Chapters 5 through 7 cover intercompany transactions in inventories, plant assets, and bonds.

Chapter 8 discusses changes in the level of subsidiary ownership, and Chapter 9 introduces more complex affiliation structures. Chapter 10 covers several consolidation-related topics: subsidiary preferred stock, consolidated earnings per share, and income taxation for consolidated business entities. Chapter 11 is a theory chapter that discusses alternative consolidation theories, push-down accounting, leveraged buyouts, corporate joint ventures, and key concepts related to accounting and reporting by variable interest entities. Chapters 9 through 11 cover specialized topics and have been written as stand-alone materials. Coverage of these chapters is not necessary for assignment of subsequent text chapters.

Business enterprises become more global in nature with each passing day. Survival of a modern business depends upon access to foreign markets, suppliers, and capital. Some of the unique challenges of international business and financial reporting are covered in Chapters 12 and 13. These chapters cover accounting for derivatives and foreign currency transactions and translations. As in the prior edition, Chapter 12 covers the concepts and common transactions for derivatives and foreign currency, and Chapter 13 covers accounting for derivative and hedging activities. Coverage includes import and export activities and forward or similar contracts used to hedge against potential exchange losses. Chapter 14 focuses on preparation of consolidated financial statements for foreign subsidiaries. This chapter includes translation and remeasurement of foreign-entity financial statements, one-line consolidation of equity method investees, consolidation of foreign subsidiaries for financial reporting purposes, and the combination of foreign branch operations.

Chapter 15 introduces topics of segment reporting under *FASB ASC Topic 280*, as well as interim financial reporting issues. Partnership accounting and reporting are covered in Chapters 16 and 17. Chapter 16 has been updated to include consideration of cases where a partnership change meets the criteria for treatment as a business combination. Chapter 18 discusses accounting and reporting procedures related to corporate liquidations and reorganizations.

Chapters 19 through 20 provide an introduction to governmental accounting, and Chapter 22 introduces accounting for voluntary health and welfare organizations, hospitals, and colleges and universities. These chapters are completely updated through *GASB Statement No. 81*, and provide students with a good grasp of key concepts and procedures related to not-for-profit accounting.

Finally, Chapter 23 provides coverage of fiduciary accounting and reporting for estates and trusts.

INSTRUCTORS' RESOURCES

The following instructors' resources are available for download at www.pearsonhighered.com:-

- **Solutions Manual:** Prepared by the authors, the solutions manual includes updated answers to questions, and solutions to exercises and problems. Solutions to assignment materials included in the electronic supplements are also included. Solutions are provided in electronic format, making electronic classroom display easier for instructors. All solutions have been accuracy-checked to maintain high-quality work.
- **Instructor's Manual:** The instructor's manual contains comprehensive outlines of all chapters, class illustrations, descriptions for all exercises and problems (including estimated times for completion), and brief outlines of new standards set apart for easy review.
- **Test Bank:** This file includes test questions in true/false, multiple-choice, short-answer, and problem formats. Solutions to all test items are also included.
- **PowerPoint Presentation:** A ready-to-use PowerPoint slideshow designed for classroom presentation is available. Instructors can use it as-is or edit content to fit particular classroom needs.

STUDENT RESOURCES

To access the student resources, visit www.pearsonhighered.com/beams. It includes problem templates for selected assignments. The templates minimize the time spent on inputting problem data, allowing students to focus their efforts on understanding the concepts and procedures.

ACKNOWLEDGMENTS

Many people have made valuable contributions to this 13th edition of *Advanced Accounting*, and we are pleased to recognize their contributions. We are indebted to the many users of prior editions for their helpful comments and constructive criticisms. We also acknowledge the help and encouragement that we received from students at Grand Valley State, Michigan State, and Central Washington University, who, often unknowingly, participated in class testing of various sections of the manuscript.

We want to thank our faculty colleagues for the understanding and support that have made 13 editions of *Advanced Accounting* possible.

A special thank you to Carolyn Streuly for her many hours of hard work and continued dedication to the project.

The following accuracy checkers and supplements authors whose contributions we appreciate—David W. Daniel, East Stroudsburg University; Darlene Ely, Carroll Community College, and Regan Garey, Lock Haven University.

We would like to thank the members of the Pearson book team for their hard work and dedication: Donna Battista, Vice President, Product Management; Adrienne D'Ambrosio, Director of Portfolio Management; Ashley Dodge, Director, Courseware Portfolio Management; Director Production–Business, Jeff Holcomb; Managing Producer, Ashley Santora; and Neeraj Bhalla, Senior Sponsoring Editor. We would also like to thank Nicole Suddeth, Editorial Project Manager, Pavithra Kumari, Full Service Project Manager from SPi Global.

Our thanks to the reviewers who helped to shape this 13th edition:

Marie Archambault, Marshall University
Ron R. Barniv, Kent State University
Nat Briscoe, Northwestern State University
Michael Brown, Tabor School of Business
Susan Cain, Southern Oregon University
Kerry Calnan, Elmus College
Eric Carlsen, Kean University
Gregory Cermignano, Widener University
Lawrence Clark, Clemson University
Penny Clayton, Drury University
Lynn Clements, Florida Southern College
David Dahlberg, The College of St. Catherine
Patricia Davis, Keystone College
David Doyon, Southern New Hampshire University
John Dupuy, Southwestern College
Thomas Edmonds, Regis University
Charles Fazzi, Saint Vincent College
Roger Flint, Oklahoma Baptist University
Margaret Garnsey, Siena College
Sheri Geddes, Andrews University
Gary Gibson, Lindsey Wilson College
Bonnie Givens, Avila University
Steve Hall, University of Nebraska at Kearney
Matthew Henry, University of Arkansas at Pine Bluff
Judith Harris, Nova Southeastern University
Joyce Hicks, Saint Mary's College
Marianne James, California State University, Los Angeles
Patricia Johnson, Canisius College
Stephen Kerr, Hendrix College
Thomas Largay, Thomas College
Stephani Mason, Hunter College
Mike Metzcar, Indiana Wesleyan University
Dianne R. Morrison, University of Wisconsin, La Crosse
David O'Dell, McPherson College
Bruce Oliver, Rochester Institute of Technology
Pamela Ondeck, University of Pittsburgh at Greensburg
Anne Oppegard, Augustana College
Larry Ozzello, University of Wisconsin, Eau Claire
Glenda Partridge, Spring Hill College
Thomas Purcell, Creighton University
Abe Qastin, Lakeland College
Donna Randolph, National American University
Frederick Richardson, Virginia Tech
John Rossi, Moravian College
Angela Sandberg, Jacksonville State University
Mary Jane Sauceda, University of Texas at Brownville and Texas Southmost College
John Schatzel, Stonehill College
Michael Schoderbeck, Rutgers University
Joann Segovia, Minnesota State University, Moorhead
Stanley Self, East Texas Baptist University
Ray Slager, Calvin College
Duane Smith, Brescia University
Keith Smith, George Washington University
Kimberly Smith, County College of Morris
Pam Smith, Northern Illinois University
Jeffrey Spear, Houghton College
Catherine Staples, Randolph-Macon College
Natalie Strouse, Notre Dame College
Zane Swanson, Emporia State University
Anthony Tanzola, Holy Family University

Christine Todd, Colorado State University, Pueblo
Ron Twedt, Concordia College
Barbara Uliss, Metropolitan State College of Denver
Joan Van Hise, Fairfield University
Dan Weiss, Tel Aviv University, Faculty of Management
Stephen Wheeler, Eberhardt School of Business
Deborah Williams, West Virginia State University
H. James Williams, Grand Valley State University
Joe Wilson, Muskingum College
Alex Yen, Suffolk University
Sung Wook Yoon, California State University, Northridge
Suzanne Alonso Wright, Penn State
Ronald Zhao, Monmouth University

This page intentionally left blank

CHAPTER 1

Business Combinations

- On November 23, 2015, ***Pfizer*** announced it would acquire ***Allergan*** for $160 billion, making Pfizer one of the world's largest healthcare firms.
- On December 31, 2008, ***Wells Fargo & Company*** acquired all of the outstanding shares of ***Wachovia Corporation*** for $23.1 billion, making Wells Fargo one of the largest U.S. commercial banks.
- In October 2001, ***Chevron*** and ***Texaco*** announced completion of their merger agreement valued in excess of $30 billion.
- In 1998, gasoline-producing rivals ***Exxon*** and ***Mobil*** merged to form ***ExxonMobil*** Corporation in a deal valued at $80 billion.

LEARNING OBJECTIVES

1.1 Understand the economic motivations underlying business combinations.

1.2 Learn about alternative forms of business combinations, from both the legal and accounting perspectives.

1.3 Introduce accounting concepts for business combinations, emphasizing the acquisition method.

1.4 See how firms record fair values of assets and liabilities in an acquisition.

1.5 Appendix: Review accounting concepts for a pooling of interests.

Welcome to the world of business combinations. There has been an unparalleled growth in merger and acquisition activities in both the United States and in international markets since the 1990s. The level of activities fluctuates with changes in stock markets, as many combinations are achieved through stock-for-stock exchanges, rather than outright cash purchases of another company.

Merger activities slowed with the stock market downturn in 2001, and again during the financial crisis of 2008, but when the market recovers, the pace picks up. The year 2015 saw stock values soar and an accompanying record level of mergers and acquisitions of over $5 trillion worldwide. Approximately half of these occurred in the United States. The following firms announced combinations in 2015. ***Allergan*** agreed to be acquired by ***Pfizer*** for $160 billion. ***Anheuser-Busch InBev*** announced the intent to acquire ***SAB Miller*** for $117.4 billion. ***HJ Heinz*** completed a purchase of ***Kraft Foods*** for $62.6 billion.

Firms strive to produce economic value added for shareholders. Related to this strategy, expansion has long been regarded as a proper goal of business entities. A business may choose to expand either internally (building its own facilities) or externally (acquiring control of other firms in business combinations). The focus in this chapter is on why firms often prefer external over internal expansion options and how financial reporting reflects the outcome of these activities.

In general terms, **business combinations** unite previously separate business entities. The overriding objective of business combinations must be increasing profitability; however, many firms can become more efficient by horizontally or vertically integrating operations or by diversifying their risks through conglomerate operations.

Horizontal integration is the combination of firms in the same business lines and markets. The combinations of Pfizer and Allergan, Chevron and Texaco, Exxon and Mobil, and Wells Fargo and

EXHIBIT 1-1

Segment Reporting at General Electric

Source: From 2014 GE Annual Report © 2015 GENERAL ELECTRIC.

NOTE 24: OPERATING SEGMENTS

Revenues (in millions)

	Total Revenues		
	2015	2014	2013
Power	$ 21,490	$ 20,580	$ 19,315
Renewable Energy	6,273	6,399	4,824
Oil & Gas	16,450	19,085	17,341
Energy Management	7,600	7,319	7,569
Aviation	24,660	23,990	21,911
Healthcare	17,639	18,299	18,200
Transportation	5,933	5,650	5,885
Appliances & Lighting	8,751	8,404	8,338
Total industrial	108,796	109,727	103,383
Capital	10,801	11,320	11,267
Corporate items and eliminations	(2,211)	(3,863)	(1,405)
Total	$117,386	$117,184	$113,245

The note goes on to provide similar detailed breakdown of intersegment revenues; external revenues; assets; property, plant, and equipment additions; depreciation and amortization; interest and other financial charges; and the provision for income taxes.

Wachovia are examples of horizontal integration. The past 25 years have witnessed significant consolidation activity in banking and other industries. ***Kimberly-Clark*** acquired ***Scott Paper***, creating a consumer paper and related products giant. ***American Airlines*** took control of its rival ***U.S. Airways*** in 2013 at a cost of $4.592 billion.

Vertical integration is the combination of firms with operations in different, but successive, stages of production or distribution, or both. In March 2007, ***CVS Corporation*** and ***Caremark Rx, Inc.***, merged to form ***CVS/Caremark Corporation*** in a deal valued at $26 billion. The deal joined the nation's largest pharmacy chain with one of the leading healthcare/pharmaceuticals service companies.

Conglomeration is the combination of firms with unrelated and diverse products or service functions, or both. Firms may diversify to reduce the risk associated with a particular line of business or to even out cyclical earnings, such as might occur in a utility's acquisition of a manufacturing company. Several utilities combined with telephone companies after the 1996 Telecommunications Act allowed utilities to enter the telephone business.

The early 1990s saw tobacco maker ***Phillip Morris Company*** acquire food producer ***Kraft*** in a combination that included over $11 billion of recorded goodwill alone. Although all of us have probably purchased a light bulb manufactured by ***General Electric Company***, the scope of the firm's operations goes well beyond that household product. Exhibit 1-1 excerpts Note 24 from General Electric's 2015 annual report on its major operating segments.

LEARNING OBJECTIVE 1.1

REASONS FOR BUSINESS COMBINATIONS

If expansion is a proper goal of business enterprise, why would a business expand through combination rather than by building new facilities? Among the many possible reasons are the following:

Cost Advantage. It is frequently less expensive for a firm to obtain needed facilities through combination than through development. This is particularly true in periods of inflation. Reduction of the total cost for research and development activities was a prime motivation in ***AT&T's*** acquisition of ***NCR***.

Lower Risk. The purchase of established product lines and markets is usually less risky than developing new products and markets. The risk is especially low when the goal is diversification. Scientists may discover that a certain product provides an environmental or health hazard. A single-product, nondiversified firm may be forced into bankruptcy by such a discovery, whereas a multiproduct, diversified company is more likely to survive. For companies in industries already plagued with excess manufacturing capacity, business combinations may be the only way to grow. When ***Toys R Us*** decided to diversify its operations to include baby furnishings and other related products, it purchased retail chain ***Baby Superstore***.

Fewer Operating Delays. Plant facilities acquired in a business combination are operative and already meet environmental and other governmental regulations. The time to market is critical, especially in the technology industry. Firms constructing new facilities can expect numerous delays in construction, as well as in getting the necessary governmental approval to commence operations. Environmental impact studies alone can take months or even years to complete.

Avoidance of Takeovers. Many companies combine to avoid being acquired themselves. Smaller companies tend to be more vulnerable to corporate takeovers; therefore, many of them adopt aggressive buyer strategies to defend against takeover attempts by other companies.

Acquisition of Intangible Assets. Business combinations bring together both intangible and tangible resources. The acquisition of patents, mineral rights, research, customer databases, or management expertise may be a primary motivating factor in a business combination. When ***IBM*** purchased ***Lotus Development Corporation***, $1.84 billion of the total cost of $3.2 billion was allocated to research and development in process.

Other Reasons. Firms may choose a business combination over other forms of expansion for business tax advantages (e.g., tax-loss carryforwards), for personal income and estate-tax advantages, or for personal reasons. One of several motivating factors in the combination of ***Wheeling-Pittsburgh Steel***, a subsidiary of ***WHX***, and ***Handy & Harman*** was Handy & Harman's overfunded pension plan, which virtually eliminated Wheeling-Pittsburgh Steel's unfunded pension liability. The egos of company management and takeover specialists may also play an important role in some business combinations.

ANTITRUST CONSIDERATIONS

Federal antitrust laws prohibit business combinations that restrain trade or impair competition. The U.S. Department of Justice and the Federal Trade Commission (FTC) have primary responsibility for enforcing federal antitrust laws. For example, in 1997 the FTC blocked ***Staples's*** proposed $4.3 billion acquisition of ***Office Depot***, arguing in federal court that the takeover would be anticompetitive. ***Office Depot*** acquired rival ***OfficeMax*** in 2013.

In 2004, the FTC conditionally approved ***Sanofi-Synthelabo SA's*** $64 billion takeover of ***Aventis SA***, creating the world's third-largest drug manufacturer. Sanofi agreed to sell certain assets and royalty rights in overlapping markets in order to gain approval of the acquisition.

Business combinations in particular industries are subject to review by additional federal agencies. The Federal Reserve Board reviews bank mergers, the Department of Transportation scrutinizes mergers of companies under its jurisdiction, the Department of Energy has jurisdiction over some electric utility mergers, and the Federal Communications Commission (FCC) rules on the transfer of communication licenses. After the Justice Department cleared a $23 billion merger between ***Bell Atlantic Corporation*** and ***Nynex Corporation***, the merger was delayed by the FCC because of its concern that consumers would be deprived of competition. The FCC later approved the merger. The merger of ***U.S. Airways*** and ***American Airlines*** faced delay and scrutiny over the reduced competitive environment, but was finally approved in December 2013.

In addition to federal antitrust laws, most states have some type of statutory takeover regulations. Some states try to prevent or delay hostile takeovers of the business enterprises incorporated within their borders. On the other hand, some states have passed antitrust exemption laws to protect hospitals from antitrust laws when they pursue cooperative projects.

Interpretations of antitrust laws vary from one administration to another, from department to department, and from state to state. Even the same department under the same administration can change its mind. A completed business combination can be re-examined by the FTC at any time. Deregulation in the banking, telecommunication, and utility industries permits business combinations that once would have been forbidden. In 1997, the Justice Department and the FTC jointly issued new guidelines for evaluating proposed business combinations that allow companies to argue that cost savings or better products could offset potential anticompetitive effects of a merger.

LEARNING OBJECTIVE 1.2

LEGAL FORM OF BUSINESS COMBINATIONS

Business combination is a general term that encompasses all forms of combining previously separate business entities. Such combinations are **acquisitions** when one corporation acquires the productive assets of another business entity and integrates those assets into its own operations. Business combinations are also acquisitions when one corporation obtains operating control over the productive facilities of another entity by acquiring a majority of its outstanding voting stock. The acquired company need not be dissolved; that is, the acquired company does not have to go out of existence.

The terms **merger** and, **consolidation** are often used as synonyms for acquisitions. However, legally and in accounting there is a difference. A merger entails the dissolution of all but one of the business entities involved. A consolidation entails the dissolution of all the business entities involved and the formation of a new corporation.

A *merger* occurs when one corporation takes over all the operations of another business entity, and that entity is dissolved. For example, Company A purchases the assets of Company B directly from Company B for cash, other assets, or Company A securities (stocks, bonds, or notes). This business combination is an acquisition, but it is not a merger unless Company B goes out of existence. Alternatively, Company A may purchase the stock of Company B directly from Company B's stockholders for cash, other assets, or Company A securities. This acquisition will give Company A operating control over Company B's assets. It will not give Company A legal ownership of the assets unless it acquires all the stock of Company B and elects to dissolve Company B (again, a merger).

A *consolidation* occurs when a new corporation is formed to take over the assets and operations of two or more separate business entities and dissolves the previously separate entities. For example, Company D, a newly formed corporation, may acquire the net assets of Companies E and F by issuing stock directly to Companies E and F. In this case, Companies E and F may continue to hold Company D stock for the benefit of their stockholders (an acquisition), or they may distribute the Company D stock to their stockholders and go out of existence (a consolidation). In either case, Company D acquires ownership of the assets of Companies E and F.

Alternatively, Company D could issue its stock directly to the stockholders of Companies E and F in exchange for a majority of their shares. In this case, Company D controls the assets of Company E and Company F, but it does not obtain legal title unless Companies E and F are dissolved. Company D must acquire all the stock of Companies E and F and dissolve those companies if their business combination is to be a consolidation. If Companies E and F are not dissolved, Company D will operate as a holding company, and Companies E and F will be its subsidiaries.

Future references in this chapter will use the term *merger* in the technical sense of a business combination in which all but one of the combining companies go out of existence. Similarly, the term *consolidation* will be used in its technical sense to refer to a business combination in which all the combining companies are dissolved, and a new corporation is formed to take over their net assets. *Consolidation* is also used in accounting to refer to the accounting process of combining parent and subsidiary financial statements, such as in the expressions "principles of consolidation," "consolidation procedures," and "consolidated financial statements." In future chapters, the meanings of the terms will depend on the context in which they are found.

Mergers and consolidations do not present special accounting problems or issues after the initial combination, apart from those discussed in intermediate accounting texts. This is because only one legal and accounting entity survives in a merger or consolidation.

ACCOUNTING CONCEPT OF BUSINESS COMBINATIONS

Generally accepted accounting principles (GAAP) define the accounting concept of a business combination as:

> *A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations.* (ASC 805-10)[1]

Note that the accounting concept of a business combination emphasizes the creation of a single entity and the independence of the combining companies before their union. Although one or more of the companies may lose its separate legal identity, dissolution of the legal entities is not necessary within the accounting concept.

Previously separate businesses are brought together into one entity when their business resources and operations come under the control of a single management team. Such control within one business entity is established in business combinations in which:

1. One or more corporations become subsidiaries;
2. One company transfers its net assets to another; or
3. Each company transfers its net assets to a newly formed corporation.

A corporation becomes a **subsidiary** when another corporation acquires a majority (more than 50 percent) of its outstanding voting stock. Thus, one corporation need not acquire all of the stock of another corporation to consummate a business combination. In business combinations in which less than 100 percent of the voting stock of other combining companies is acquired, the combining companies necessarily retain separate legal identities and separate accounting records even though they have become one entity for financial reporting purposes.

Business combinations in which one company transfers its net assets to another can be consummated in a variety of ways, but the acquiring company must acquire substantially all the net assets in any case. Alternatively, each combining company can transfer its net assets to a newly formed corporation. Because the newly formed corporation has no net assets of its own, it issues its stock to the other combining companies or to their stockholders or owners.

A Brief Background on Accounting for Business Combinations

Accounting for business combinations is one of the most important and interesting topics of accounting theory and practice. At the same time, it is complex and controversial. Business combinations involve financial transactions of enormous magnitudes, business empires, success stories and personal fortunes, executive genius, and management fiascos. By their nature, they affect the fate of entire companies. Each is unique and must be evaluated in terms of its economic substance, irrespective of its legal form.

Historically, much of the controversy concerning accounting requirements for business combinations involved the **pooling of interests method**, which became generally accepted in 1950. Although there are conceptual difficulties with the pooling method, the underlying problem that arose was the introduction of alternative methods of accounting for business combinations (pooling versus purchase). Numerous financial interests are involved in a business combination, and alternate accounting procedures may not be neutral with respect to different interests. That is, the individual financial interests and the final plan of combination may be affected by the method of accounting.

Until 2001, accounting requirements for business combinations recognized both the pooling and purchase methods of accounting for business combinations. In August 1999, the Financial Accounting Standards Board (FASB) issued a report supporting its proposed decision to eliminate pooling. Principal reasons cited included the following:

- Pooling provides less relevant information to statement users.
- Pooling ignores economic value exchanged in the transaction and makes subsequent performance evaluation impossible.
- Comparing firms using the alternative methods is difficult for investors.

Pooling creates these problems because it uses historical book values to record combinations, rather than recognizing fair values of net assets at the transaction date. GAAP generally require recording asset acquisitions at fair values.

[1] FASB ASC 805-10. Originally Statement of Financial Accounting "Business Combinations." Stamford, CT: Financial Accounting Standards Board, 2016.

Further, the FASB believed that the economic notion of a pooling of interests rarely exists in business combinations. More realistically, virtually all combinations are acquisitions, in which one firm gains control over another.

GAAP eliminated the pooling of interests method of accounting for all transactions initiated after June 30, 2001. (ASC 805) Combinations initiated subsequent to that date must use the acquisition method. Because the new standard prohibited the use of the pooling method only for combinations initiated after the issuance of the revised standard, prior combinations accounted for under the pooling of interests method were grandfathered; that is, both the acquisition and pooling methods continue to exist as acceptable financial reporting practices for past business combinations.

Therefore, one cannot ignore the conditions for reporting requirements under the pooling approach. On the other hand, because no new poolings are permitted, this discussion focuses on the acquisition method. More detailed coverage of the pooling of interests method is relegated to the Appendix to this chapter.

International Accounting Elimination of pooling made GAAP more consistent with international accounting standards. Most major economies prohibit the use of the pooling method to account for business combinations. International Financial Reporting Standards (IFRS) require business combinations to be accounted for using the acquisition method, and specifically prohibit the pooling of interests method. In introducing the new standard, International Accounting Standards Board (IASB) Chairman Sir David Tweedie noted:

> *Accounting for business combinations diverged substantially across jurisdictions. IFRS 3 marks a significant step toward high quality standards in business combination accounting, and in ultimately achieving international convergence in this area.* (IFRS 3)[2]

Accounting for business combinations was a major joint project between the FASB and IASB. As a result, accounting in this area is now generally consistent between GAAP and IFRS. Some differences remain, and we will point them out in later chapters as appropriate.

LEARNING OBJECTIVE 1.3

ACCOUNTING FOR COMBINATIONS AS ACQUISITIONS

GAAP requires that all business combinations initiated after December 15, 2008, be accounted for as acquisitions. (ASC 810-10) The **acquisition method** follows the same GAAP for recording a business combination as we follow in recording the purchase of other assets and the incurrence of liabilities. We record the combination using the fair-value principle. In other words, we measure the cost to the purchasing entity of acquiring another company in a business combination by the amount of cash disbursed or by the fair value of other assets distributed or securities issued.

We expense the direct costs of a business combination (such as accounting, legal, consulting, and finder's fees) other than those for the registration or issuance of equity securities. We charge registration and issuance costs of equity securities issued in a combination against the fair value of securities issued, usually as a reduction of additional paid-in capital. We expense indirect costs such as management salaries, depreciation, and rent under the acquisition method. We also expense indirect costs incurred to close duplicate facilities.

NOTE TO THE STUDENT

The topics covered in this text are sometimes complex and involve detailed exhibits and illustrative examples. Understanding the exhibits and illustrations is an integral part of the learning experience, and you should study them in conjunction with the related text. Carefully review the exhibits as they are introduced in the text. Exhibits and illustrations are designed to provide essential information and explanations for understanding the concepts presented.

Understanding the financial statement impact of complex business transactions is an important element in the study of advanced financial accounting topics. To assist you in this learning endeavor, this book depicts journal entries that include the types of accounts being affected and the directional impact of the event. Conventions used throughout the text are as follows: A parenthetical reference added to each account affected by a journal entry indicates the type of account and the effect of the entry. For example, an increase in accounts receivable, an asset account, is denoted as "Accounts receivable (+ A)." A decrease in this account is denoted as "Accounts receivable(− A)." The symbol (A) stands for assets, (L) for liabilities, (SE) for stockholders' equity accounts, (R) for revenues, (E) for expenses, (Ga) for gains, and (Lo) for losses.

[2] © IFRS 3. "Business Combinations." London, UK: International Accounting Standards Board, 2004.

To illustrate, assume that Pop Corporation issues 100,000 shares of $10 par common stock for the net assets of Son Corporation in a business combination on July 1, 2016. The market price of Pop common stock on this date is $16 per share. Additional direct costs of the combination consist of Securities and Exchange Commission (SEC) fees of $5,000, accountants' fees in connection with the SEC registration statement of $10,000, costs for printing and issuing the common stock certificates of $25,000, and finder's and consultants' fees of $80,000.

Pop records the issuance of the 100,000 shares on its books as follows (in thousands):

Investment in Son (+A)	1,600	
Common stock, $10 par (+SE)		1,000
Additional paid-in capital (+SE)		600

To record issuance of 100,000 shares of $10 par common stock with a market price of $16 per share in a combination with Son Corporation.

Pop records additional direct costs of the business combination as follows:

Investment expense (E, −SE)	80	
Additional paid-in capital (−SE)	40	
Cash (or other net assets) (−A)		120

To record additional direct costs of combining with Son Corporation: $80,000 for finder's and consultants' fees and $40,000 for registering and issuing equity securities.

We treat registration and issuance costs of $40,000 as a reduction of the fair value of the stock issued and charge these costs to Additional paid-in capital. We expense other direct costs of the business combination ($80,000). The total cost to Pop of acquiring Son is $1,600,000, the amount entered in the Investment in Son account.

We accumulate the total cost incurred in purchasing another company in a single-investment account, regardless of whether the other combining company is dissolved or the combining companies continue to operate in a parent–subsidiary relationship. If we dissolve Son Corporation, we record its identifiable net assets on Pop's books at fair value and record any excess of investment cost over fair value of net assets as goodwill. In this case, we allocate the balance recorded in the Investment in Son account by means of an entry on Pop's books. Such an entry might appear as follows (in thousands):

Receivables (+A)	XXX	
Inventories (+A)	XXX	
Plant assets (+A)	XXX	
Goodwill (+A)	XXX	
Accounts payable (+L)		XXX
Notes payable (+L)		XXX
Investment in Son (−A)		1,600

To record allocation of the $1,600,000 cost of acquiring Son Corporation to identifiable net assets according to their fair values and to goodwill.

If we dissolve Son Corporation, we formally retire the Son Corporation shares. The former Son shareholders are now shareholders of Pop.

If Pop and Son Corporations operate as parent company and subsidiary, Pop will not record the entry to allocate the Investment in Son balance. Instead, Pop will account for its investment in Son by means of the Investment in Son account, and we will make the assignment of fair values to identifiable net assets required in the consolidation process.

Because of the additional complications of accounting for parent–subsidiary operations, the remainder of this chapter is limited to business combinations in which a single acquiring entity receives the net assets of the other combining companies. Subsequent chapters cover parent–subsidiary operations and the preparation of consolidated financial statements.

LEARNING OBJECTIVE 1.4

Recording Fair Values in an Acquisition

The first step in recording an acquisition is to determine the fair values of all identifiable tangible and intangible assets acquired and liabilities assumed in the combination. This can be a monumental task, but much of the work is done before and during the negotiating process for the proposed merger. Companies generally retain independent appraisers and valuation experts to determine fair values. GAAP provides guidance on the determination of fair values. There are three levels of reliability for fair-value estimates. (ASC 820-10) Level 1 is fair value based on established market prices. Level 2 uses the present value of estimated future cash flows, discounted based on an observable measure such as the prime interest rate. Level 3 includes other internally derived estimations. Throughout this text, we assume that total fair value is equal to the total market value, unless otherwise noted.

We record identifiable assets acquired, liabilities assumed, and any noncontrolling interest using fair values at the acquisition date. We determine fair values for all identifiable assets and liabilities, regardless of whether they are recorded on the books of the acquired company. For example, an acquired company may have expensed the costs of developing patents, blueprints, formulas, and the like. However, we assign fair values to such identifiable intangible assets of an acquired company in a business combination accounted for as an acquisition. (ASC 750-10)

Assets acquired and liabilities assumed in a business combination that arise from contingencies should be recognized at fair value if fair value can be reasonably estimated. If the fair value of such an asset or liability cannot be reasonably estimated, the asset or liability should be recognized in accordance with general FASB guidelines to *account for contingencies*. It is expected that most litigation contingencies assumed in an acquisition will be recognized only if a loss is probable and the amount of the loss can be reasonably estimated. (ASC 450)

There are few exceptions to the use of fair value to record assets acquired and liabilities assumed in an acquisition. Deferred tax assets and liabilities arising in a combination, pensions and other employee benefits, and leases should be accounted for in accordance with normal guidance for these items. (ASC 740)

We assign no value to the goodwill recorded on the books of an acquired subsidiary because such goodwill is an unidentifiable asset and because we value the goodwill resulting from the business combination directly: (ASC 715 and ASC 840-10)

> *The acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b):*
>
> **a.** *The aggregate of the following:*
> **1.** *The consideration transferred measured in accordance with this Section, which generally requires acquisition-date fair value (ASC 805-30-30-7)*
> **2.** *The fair value of any noncontrolling interest in the acquiree*
> **3.** *In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree*
>
> **b.** *The net of the acquisition-date [fair value] amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Topic*[3]

Recognition and Measurement of Other Intangible Assets GAAP (ASC 805-20) clarifies the recognition of intangible assets in business combinations under the acquisition method. Firms should recognize intangibles separate from goodwill only if they fall into one of two categories. Recognizable intangibles must meet either a separability criterion or a contractual-legal criterion.

GAAP defines intangible assets as either current or noncurrent assets (excluding financial instruments) that lack physical substance. Per GAAP:

> *The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either*

[3] FASB ASC 805-30-30-1 Originally Statement of Financial Accounting "Business Combinations." Stamford, CT: Financial Accounting Standards Board, 2010.

> *the separability criterion or the contractual-legal criterion described in the definition of identifiable.*
>
> *The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it. . . .*
>
> *An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them. . . .*
>
> *An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset, or liability. (ASC 805-30)*[4]

Intangible assets that are not separable should be included in goodwill. For example, acquired firms will have a valuable employee workforce in place, but this asset cannot be recognized as an intangible asset separately from goodwill. GAAP (reproduced in part in Exhibit 1-2) provides more detailed discussion and an illustrative list of intangible assets that firms can recognize separately from goodwill.

Contingent Consideration in an Acquisition A business combination may provide for additional payments to the previous stockholders of the acquired company, contingent on future events or transactions. The contingent consideration may include the distribution of cash or other assets or the issuance of debt or equity securities.

Contingent consideration in an acquisition must be measured and recorded at fair value as of the acquisition date as part of the consideration transferred in the acquisition. In practice, this requires the acquirer to estimate the amount of consideration it will be liable for when the contingency is resolved in the future.

The contingent consideration can be classified as equity or as a liability. An acquirer may agree to issue additional shares of stock to the acquiree if the acquiree meets an earnings goal in the future. Then, the contingent consideration is in the form of equity. At the date of acquisition, the Investment and Paid-in Capital accounts are increased by the fair value of the contingent consideration. Alternatively, an acquirer may agree to pay additional cash to the acquiree if the acquiree meets an earnings goal in the future. Then, the contingent consideration is in the form of a liability. At the date of the acquisition, the Investment and Liability accounts are increased by the fair value of the contingent consideration.

The accounting treatment of subsequent changes in the fair value of the contingent consideration depends on whether the contingent consideration is classified as equity or as a liability. If the contingent consideration is in the form of equity, the acquirer does not remeasure the fair value of the contingency at each reporting date until the contingency is resolved. When the contingency is settled, the change in fair value is reflected in the equity accounts. If the contingent consideration is in the form of a liability, the acquirer measures the fair value of the contingency at each reporting date until the contingency is resolved. Changes in the fair value of the contingent consideration are reported as a gain or loss in earnings, and the liability is also adjusted. (ASC 805-30)

Cost and Fair Value Compared After assigning fair values to all identifiable assets acquired and liabilities assumed, we compare the investment cost with the total fair value of identifiable assets less liabilities. If the investment cost exceeds net fair value, we first assign the excess to identifiable net assets according to their fair values and then assign the rest of the excess to goodwill.

In some business combinations, the total fair value of identifiable assets acquired over liabilities assumed may exceed the cost of the acquired company. The gain from such a **bargain purchase** is recognized as an ordinary gain by the acquirer.

[4] FASB ASC 805-20-55-11 through 55-38. Originally Statement of Financial Accounting Standards No. 141(R). "Business Combinations." Appendix A. Norwalk, CT: Financial Accounting Standards Board, 2007.